



Reporting Season Wrap & Outlook

March 2015

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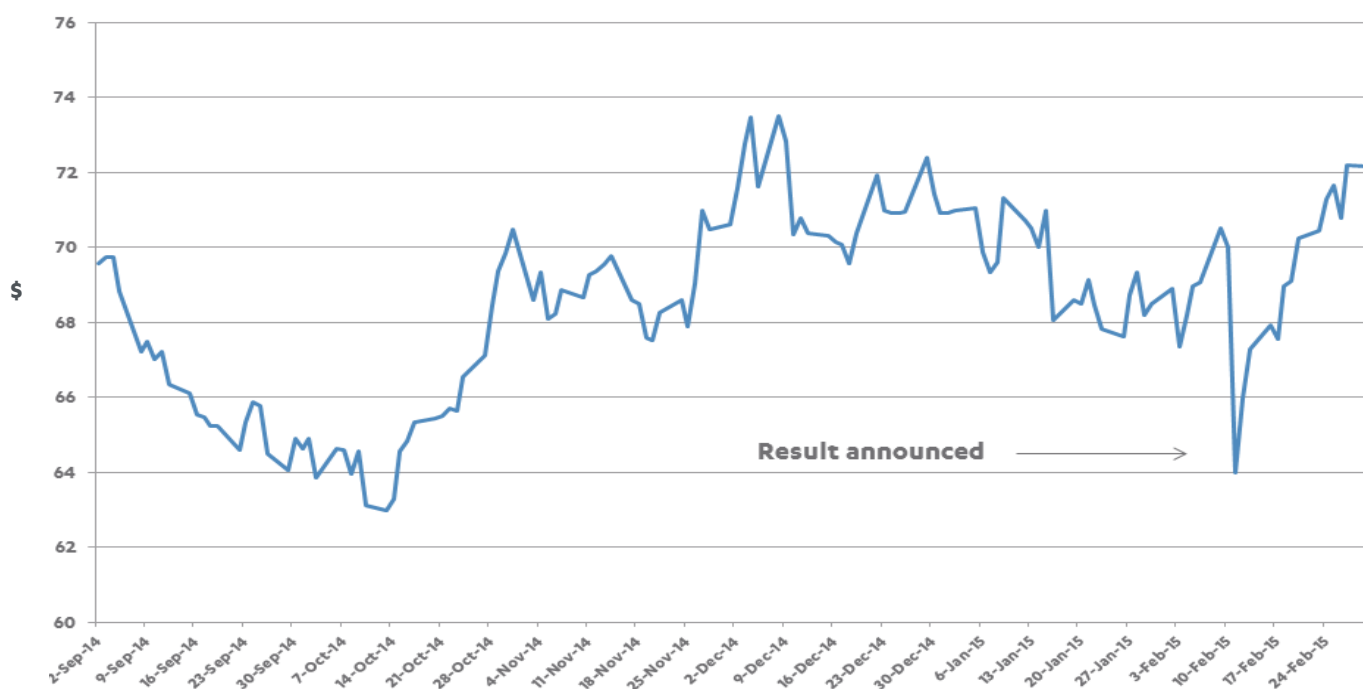
Executive summary

For the Australian sharemarket the start of 2015 has been stronger than anyone expected. The reporting season's effect on share prices was swamped by February's interest rate cut, the Europeans jumping on the QE bandwagon and the falling Australian dollar. The net effect was very strong liquidity, which drove the best monthly gain in three years.

- > Reporting season results were reasonable; earnings certainty increased at the margin.
- > Cost reduction was a key driver of earnings – particularly in the resources sector. A weaker Australian dollar also helped.

- > The focus on returning capital to shareholders remained in place. Dividend payout ratios continued to increase, leading to convergence of yield across the market.
- > Downgrades in resources were more a function of the market "catching up" to weaker commodity prices, rather than an underlying deterioration in conditions.
- > The market remains at elevated valuations, but low interest rates and QE-fuelled liquidity can continue to support equities.
- > We expect the market to consolidate from here, with rotation of traditional yield into stocks with some cyclical tail-winds.

Figure 1: CSL Limited stock price over 12 months



Source: BTIM, Factset as at March 3 2015

A 'reasonable' report card

Perhaps the best word to describe the H1 FY15 reporting season is "reasonable". There were a few nasty surprises for the market, but not as many as might be expected given the lacklustre economic environment. While the certainty around earnings improved a little at the margins, in aggregate the reporting season confirmed current consensus expectations of an absence of earnings growth in FY15.

One observation from the reporting season is how little it seemed to matter to the market, which rose just shy of 7% for the ASX200 in February – the best monthly gain for over three years. The interest rate cut in early February and persistently high levels of QE-fuelled liquidity have been far more influential in driving returns.

Both foreign and domestic investors are being forced into equity markets as lower rates and compressed bond yields squeeze the returns from other asset classes. Hence we had stocks such as CSL which shed 9% on the day it reported disappointing revenue growth and guidance.

Yet as Figure 1 shows, by the end of the month it had attained new highs for the year, buoyed by a market looking for high quality beta. It is probably fair to say that while reporting season was not inspiring, it has delivered enough to maintain the current demand for equities.



Liquidity a positive in short term

The point about liquidity in the market is that perception is a powerful thing. Just the perception that people will seek to move money out of term deposits into the market will support the rating. Similarly, the fact that in US dollar terms the Australian market has been a laggard to global peers in recent years – it has been effectively flat for five years – has no doubt seen us out of favour.

The steep fall in the currency in US dollar terms will now provide credence to the idea that more liquidity will find its way back into our market as investors become more comfortable with the currency helped by the Reserve Bank further supporting the economy. Again, just the idea can support the rating.

Valuations uncomfortable, but low interest rates can support ratings

So where does that leave us? Certainly on a ten year time frame the current PE does look high. If we were to experience some kind of exogenous shock to the system then the market looks vulnerable at these levels. This obviously makes us uncomfortable.

However, on a longer term perspective we can see that in low interest rate environments these kind of multiples can be sustained - and Figure 2 shows when the Reserve Bank is in loosening mode the PE of the market rarely, if ever, falls.

So the key outlook then is around interest rates, which we believe will head lower from here and is likely to stay low for some time. In effect, policy makers are buying insurance as they see unemployment rising and mining capex continuing to fall. We do not see the Reserve Bank deviating from the current path until they see the rest of the economy start to kick into gear via higher consumer spending and increased investment as a result of a more competitive Australian dollar.

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Figure 2: S&P/ASX300 12 month price earnings ratio

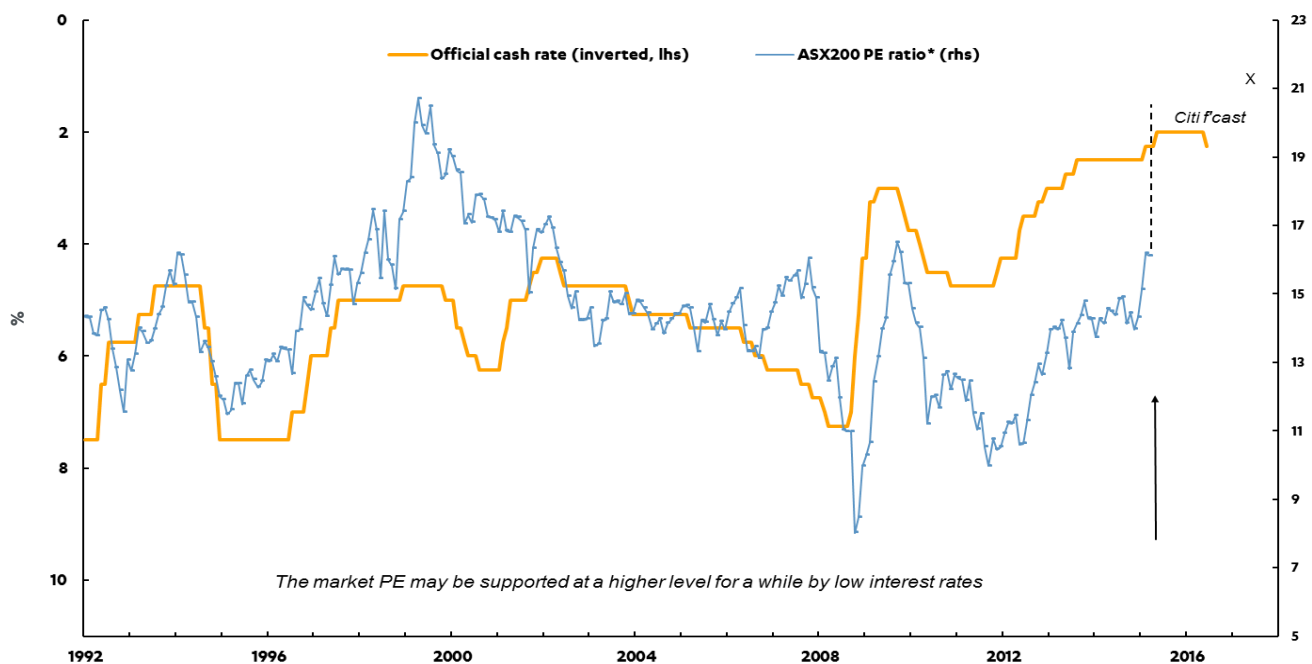


Source: BT, IRESS, Datastream

So in general – yes, the market is vulnerable to geo-political risk given its high valuation. But equally a further re-rate is by no means out of the question. What we are likely to see – and this was borne out through reporting season – is that certain parts of the market are likely to be winners either through a supportive cycle (e.g those helped by low rates and a lower Australian dollar) or by demonstration of successful ‘self-help’ initiatives.

Conversely stocks that have been bid up based on either their solid franchise or high yield characteristics will be harshly dealt with if they don’t meet expectations, given stretched valuations.

Figure 3: Interest rates and market PE ratio



Source: Citi Research

Reporting season saw high earnings dispersion

There is a great deal of dispersion beneath the flat-to-slightly negative earnings expectation for the ASX200. As illustrated in Figure 4, it is the resources sector which has dragged down aggregate estimates, while banks and the remaining industrials are expected to deliver mid-to-high single digit growth. It is worth mentioning that the underlying earnings for the resource sector were relatively stable, despite the downgrades. In many instances, the market had simply been behind the curve in terms of factoring in depressed commodity prices and is only now updating its outlook.

From a stock perspective, we remain cautious on resource stocks – even one the ones we like. Take Rio Tinto, for example. It is a great business with an edge

over its competition, it has cut costs ahead of plan, reduced future capex, demonstrated discipline in capacity management and increased returns to shareholders. But questions remain around how it is going to keep growing profits in light of falling commodity prices, ever increasing supply levels and falling demand amid structurally lower Chinese industrial production, as the economy slowly adapts to be more consumer oriented.

The transition from a resource-led economy continues to weigh on corporate Australia, with little to pick up the slack despite some pockets of strength like construction. This macro headwind outweighed incremental help from lower interest expenses, energy costs and a depreciating Australian dollar.

Figure 4: Consensus earnings per share (EPS) growth expectations before and after reporting season

	20 Jan 2015			2 Mar 2015		
	FY14	FY15	FY16	FY14	FY15	FY16
ASX 200	10.9	1.3	8.9	11.2	-2.1	7.6
Resources	23.0	-13.3	10.3	24.0	-23.3	5.6
Banks	4.7	7.6	5.2	4.7	7.5	5.0
Industrials ex-banks	6.8	8.6	10.6	6.7	8.4	10.4

Source: Citi Research, IBES, S&P

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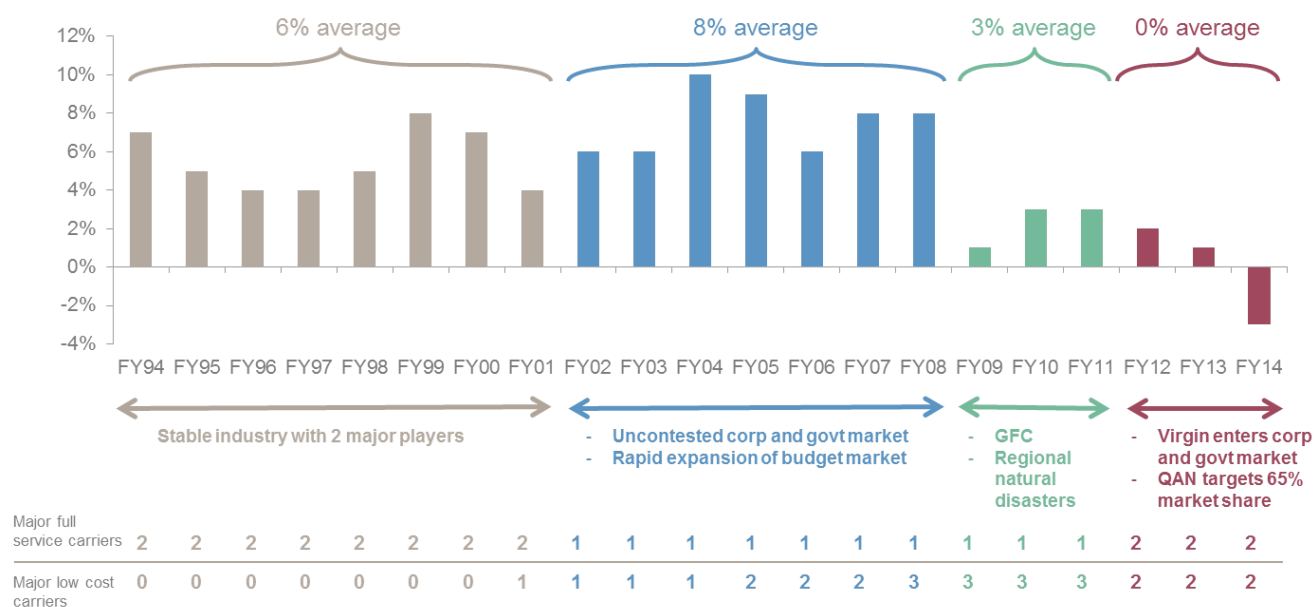
'Self-helpers' well rewarded

The market rewarded companies which displayed evidence of self-help in response to a challenging environment. Qantas is a good example. It is notoriously difficult to generate high returns in the airline industry, given high capital intensity and the commodity-like nature of its product. Nevertheless, as Figure 5 shows, at points in the cycle the pain becomes so great that

remedial action is required and, if this is implemented well, returns start to improve. We are seeing this with Qantas, which has been spurned by the market for some time despite recent indications that a turnaround in profits has been likely. Its half-yearly results confirmed a return to profitability and the stock has responded – helped also by the falling oil price.

Figure 5: Declining profits in the Australian airline industry

Industry EBIT Margin (June 1994 to June 2014)



Source: Virgin Australia, Qantas, Tigerair Australia, Ansett, Rex Airlines

Stocks with high multiples that didn't deliver were punished

In contrast, some companies are displaying vulnerabilities as a result of recent strategy. Woolworths is facing an increasingly competitive environment and is seeing sales decelerate, despite being a great quality franchise.

We have been worried for some time that management has not been reinvesting its efficiency gains into their pricing strategy and that prices remain too high as a consequence.

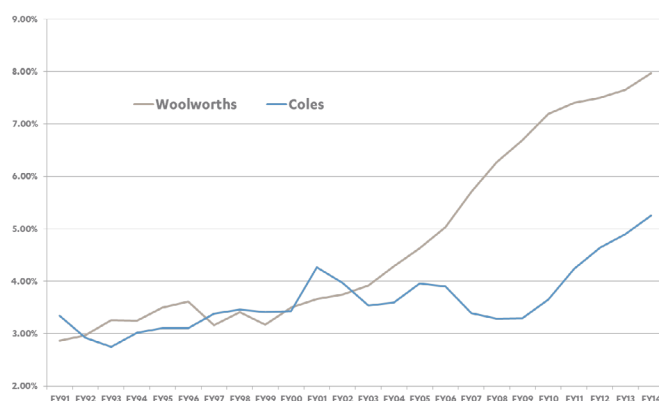
Profits have been strong, as illustrated in Figure 6, but this is unsustainable – strong profitability will generally attract competitors as we are seeing in the discount retailers.

Management conceded this in its update and admitted that the strategy needs to change, which is encouraging, but the stock fell on the increased uncertainty that this change entails.

This is a good example of a stock with a high multiple falling short of lofty expectations and being punished as a result.

Figure 6: Woolworths' unsustainable profits

Supermarkets EBIT margin



Source: IRESS

There are still some cyclical tailwinds

There are also a few stocks which do find themselves with cyclical tailwinds in an otherwise low-growth environment. Macquarie Group is benefiting from a low-rate environment, enabling it to raise cash and deploy it in bolt-on, earnings-accretive acquisitions. Crucially, it has changed its business model from a reliance on transaction-driven investment banking to a greater focus on a portfolio of businesses such as aircraft leasing and asset management, delivering more predictable annuity streams.

The two major themes from reporting season remain unchanged from six months ago; capital management and cost control. Companies continue to respond to investor desire for income through increased dividends and share buybacks. It was interesting to note that reporting CFOs and CEOs all knew their franking credit balances off the top of their heads, which has not been the case in the past.

Corporate Australia has recognised that investors want income – and that their stock will perform if they can deliver it. Hence we have the situation where aggregate dividends per share for the market are expected to grow 2% even as earnings are falling.

Woolworths' profits have been strong - but this is unsustainable

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Dividend yields have converged dramatically

The outperformance of traditional high yield stocks has compressed dividend yields, while across the rest of the market many are increasing payout ratios.

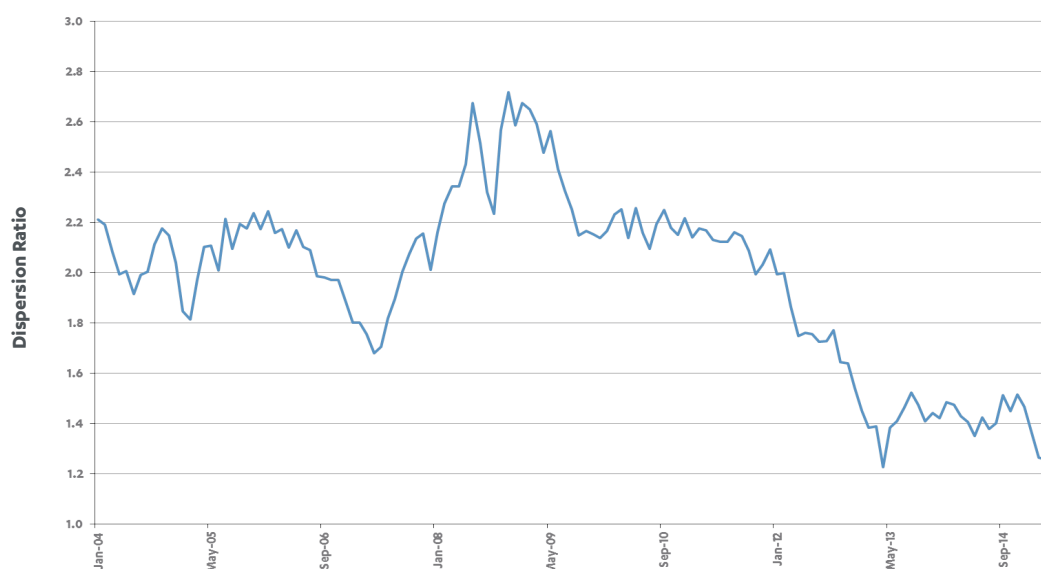
The divergence in yield across the market is the lowest it has been for 15 years. For example, there is the highly unusual situation of the Commonwealth Bank and Rio Tinto having similar dividend yields. This has important implications for portfolio construction. For the last few years investors would have done very well by simply favouring defensive yield stocks. In today's environment the valuations of those stocks appear less sustainable given limited earnings growth, while potentially higher dividend growth across some more cyclical parts of the market creates scope for further re-rating.

What earnings growth there is continues to be driven largely by cost reduction, in the absence of strong growth in revenue. For example, industrials ex financials delivered 2.8% sales growth in FY14, and about the same in terms of cost growth. At this stage, sales growth for FY15 is tracking

at around 1.4%, but cost growth has been slashed to 0.6%, according to Citi forecasts. Declining energy and interest costs have played their part, however companies are also aggressively addressing cost through structural changes and slashing capex. Heavyweight resource companies Rio Tinto and BHP have actually seen EBIT margin forecasts improve on the back of significant cost reduction. Profits are still likely to decline, but by less than many expected.

There is a natural limit to how much cost can be taken out of businesses. Falling energy prices and a depreciating currency may continue to provide some relief in the near term, but at some stage revenues will need to recover in order to return to significant earnings growth. To this end, the Reserve Bank looks set to keep rates low for some time in order to stimulate the non-mining portion of the economy.

Figure 7: Dispersion across sector dividend yields



Source: Goldman Sachs

So where to from here?

The recent rally has taken the broad market to a 10% premium to its long-term PE valuation and it is hard to see the market advance at its current rate, without earnings growth to support it. As we have pointed out, history shows that low-rate environments can support elevated valuations for extended periods of time. On this basis there is currently no reason to be overly pessimistic

Yet there is certainly scope for rotation within the market. Any move towards higher interest rates in the US may see the defensive yield stocks underperform. At the same time, there is a cohort of high-growth, high-valuation stocks which have done well in recent times – the premium placed on growth having expanded in the current low-growth environment. They have run hard in recent months and do look a little vulnerable.

There are, in contrast, pockets within the market that combine strong earnings growth with reasonable valuation. Several also have the added benefit of an improving dividend yield based on the dual benefit of higher free cash flows (as capex falls away) and higher payout ratios. While ‘traditional yield’ may have been the mainstay of portfolios in recent years, we believe the mantle for future outperformance has well and truly moved to the ‘emerging yield’ category.



Key positions

A quick results summary of our key overweight positions



Telstra

- > A good result, with better revenue than expected and upward earnings revisions. The market applauded its plan to revive the dividend reinvestment plan.
 - > It is managing to grow market share in mobile phones, despite stiffer competition. It added 366,000 new subscribers in the last six months.
 - > The stock underperformed the index in February, along with other high yield names, following their strong run in January.
 - > Telstra remains our preferred defensive yield position, given the fact it is at cheaper valuations – and is spending far less to achieve growth than its “bond proxy” peers.
-



Qantas

- > A strong result as the company returned to profitability. While it has benefited from lower oil prices, the turnaround was driven primarily by cost cutting and increased revenue per seat following a halt to capacity growth.
 - > The stock continued its strong run. While this had been sparked originally by the oil price collapse, it now also reflects confidence in management’s strategy.
 - > We believe the company is still cheap, despite its recent gains and allowing for the traditional discount for airline stocks.
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Twenty First Century Fox

- > Fox downgraded EBITDA when reporting in the US in early February. This was driven primarily by the currency impact of its significant Euro revenues as the US dollar appreciates.
- > However, the US dollar rise also ameliorates the effect on the Australian dollar value of the fund’s holdings.
- > The stock is set to deliver over 20% earnings growth this year, which is not reflected in the current price. It had bounced back by the end of the month.



Asciano

- > Announced flat first-half net profit after tax. The interim dividend rose from 5.75 cents per share to 8.25 cents. This is in keeping with our expectation that management would increase their pay-out ratio as cash flows improved on the back of reduced costs and capex.
 - > The company remains on track to deliver 10% EBIT growth for the year, having delivered 4.7% growth in H1.
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Macquarie Group

- > Macquarie indicated at its trading update that it expected full year profits to come in at the upper end of its indicative range – which was itself increased in January.
 - > The stock has done well in recent times as the market has been focused on its commodity exposure, which has had little effect. Instead, the depreciating Australian dollar has been a material driver of earnings.
 - > We believe Macquarie is one of the few companies benefiting from a cyclical tailwind, benefiting from an environment of cheap funding as it looks to make accretive acquisitions.
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Resmed

- > Second quarter profit rose 5%, driven by a 10% rise in revenue on the back of new product launches and increased volumes in key markets.
- > It beat market expectations, shrugging off the headwind of a depreciating Euro on its US dollar denominated earnings.
- > The company's stock continues to be very sensitive to changes in its revenue but the outlook here is positive given a strong product cycle.

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